Problems with Australian Franchising
September 3, 2008

A major problem with Australian franchising is the quality of disclosure provided under the Franchise Code and the lax enforcement of the disclosure provisions of that code.

A most significant omission is the lack of a requirement for a company to change its disclosure document if it encounters difficulties such as the appointment of an administrator or receiver during a current financial year. The quality of reporting during the financial year is far less stringent than that for public companies. Yet, franchisees, typically, have far more invested in their businesses than average shareholders in their shares.

Few franchisors have been prosecuted for issuing false disclosure documents or not issuing them at all. It is doubtful if the average franchisor is aware of the penalties levied for non-compliance with disclosure requirements.

To properly evaluate whether the disclosure provisions are working, the committee needs enquire as to:

- **The number of prosecutions.**
- **How many prosecuted franchisors have been found guilty or agreed to substantial settlements?**
- **The type and quantum of penalties levied in each case.**

One could logically conclude that current disclosure legislation is worse than none because it lulls potential franchisees into a false sense of security. The rhetoric surrounding the Franchise Code often misleads franchisees to believe that they have recourse when franchisors mislead or cheat them. The harsh reality is that the products of full and proper franchisor disclosure, the penalties that lack of proper and full disclosure bring and Franchise Code enforcement do not live up to their promises.

It is a sad, but true fact that franchisees cheated by crooked franchisors or seriously disadvantaged when incompetent franchisors go broke, have very little chance of winning in court.

Australia's legal system, when compared with that of the United States, severely disadvantages franchisees seeking legal redress. Australia's legal system requires solicitors to instruct barristers. Consequently, those with the deepest pockets usually win. Australian lawyers don't work on contingency; there are few class actions and Australian courts level only compensatory damages.

Contrast this with the United Sates where lawyers on contingency arrangements are paid only if they win, courts award treble punitive damages and class actions are easily brought.

Franchisees' difficulties in securing legal redress should put great pressure on the ACCC to pursue dishonest franchisors. Currently, many shady and borderline franchisors operate with impunity.

Appendix 1 outlines penalties assessed by the USA Federal Trade Commission

ACTION IN GOOD FAITH

Franchising, while promoted as an efficient and effective way for small business people to "be in business for themselves, but not by themselves", is usually not an arrangement between equals.

While mediation is promoted as an effective tool in resolving franchisor/franchisee disputes, a franchisor that chooses not to accept mediation, leaves aggrieved franchisees with no other option but litigation, an action beyond most franchisees' financial capability. In most cases, franchisors that leave aggrieved franchisees with no option other than litigation, are not acting in good faith.

As franchising has come of age in Australia and franchise agreements come to the end of their terms, some franchisors are choosing not to renew franchise agreements.

Franchisors claim that their franchise agreements were freely negotiated. In fact, it is a basic precept of franchising that franchise agreements should never be negotiated to ensure that no individual franchisee gets a better deal than another.

Franchises are sold on a take it or leave it basis. This is acceptable for operational standards, fees and reporting requirements. Most potential franchisees are not sophisticated business people and few look at the long term consequences of their investment.

Renewal provisions are noted, but not highlighted. The euphoria of starting a new business is not conducive to the new franchisee considering what may happen in 10 or 20 years.

To say, "a contract is a contract" freely entered into, completely ignores the relative bargaining power of the parties. People in business "for themselves, but not by themselves", are entitled to proceed on the basis that their dealings are in good faith. Capricious non-renewal, when a franchise term ends, yet the franchisee has not breached the franchise agreement is not dealing in good faith; particularly when the end of the franchise is accompanied by a non-compete clause.

The New South Wales government deals with unconscionability by way Section 88F of its Industrial Arbitration Act. While non-renewal has not been tested under this act, it may be.

Parliament should consider introducing unconscionability provisions as to renewal by way of amending the franchising code or Section 51AC of the Trade Practices Act.

OTHER ISSUES

There are two types of franchisors; those that are in the business of franchising and those that are in the business of selling franchises. The ACCC should be in a position to separate the franchise sellers from the franchise operators. Franchise sellers foment unwarranted franchise churn which can cost franchisees their life's savings, their homes, sometimes their marriages and even their lives through suicide.

If a company trades while insolvent, directors are personally liable. The directors of franchisor companies that are not necessarily insolvent, but are not in a position to meet their obligations to franchises are not personally liable when the franchise company goes broke. Is this equitable?

The ACCC's Franchise Consultative Council appears to function more as an arm of the Franchise Council of Australia than as an independent body seeking views from franchisors, franchisees and various franchise advisors. Is this equitable?

Parliament may well have a better feel for franchising if it recognizes it as a distribution channel and a method of doing business, rather that as an industry.

APPENDIX 1

V. Potential Liability for Violations
A. FTC Action: Rule violations may subject franchisors, franchise brokers, their officers and agents to significant liabilities in FTC enforcement actions.
1. Remedies: The FTC Act provides the Commission with a broad range of remedies for Rule violations:
a. Injunctions: Section 13(b) of the Act authorizes preliminary and permanent injunctions against Rule violations (15 U.S.C. § 53(b)). Rule cases routinely have sought and obtained injunctions against Rule violations and misrepresentations in the offer or sale of any business venture, whether or not covered by the Rule.
b. Asset Freezes: Acting under their inherent equity powers, the courts have routinely granted preliminary asset freezes in appropriate Rule cases. The assets frozen have included both corporate assets and the personal assets, including real and personal property, of key officers and directors.
c. Civil Penalties: Section 5(m)(1)(A) of the Act authorizes civil penalties of up to $11,000 for each violation of the Rule (15 U.S.C. § 5(m)(1)(A)). The courts have granted civil penalties of as much as $870,000 in a Rule case to date.
d. Monetary Redress: Section 19(b) of the Act authorizes the Commission to seek monetary redress on behalf of investors injured economically by a Rule violation (15 U.S.C. § 57b). The courts have granted consumer redress of as much as $4.9 million in a Rule case to date.
e. Other Redress: Section 19(b) of the Act also authorizes such other forms of redress as the court finds necessary to redress injury to consumers from a Rule violation, including rescission or reformation of contracts, the return of property and public notice of the Rule violation. Courts may also grant similar relief under their inherent equity powers.
2. Personal Liability: Individuals who formulate, direct and control the franchisor's activities can expect to be named individually for violations committed in the franchisor's name, together with the franchisor entity, and held personally liable for civil penalties and consumer redress.
3. Liability For Others: Franchisors and their key officers and executives are responsible for violations by persons acting in their behalf, including independent franchise brokers, sub-franchisors, and the franchisor's own sales personnel.
B. Private Actions: The courts have held that the FTC Act generally may not be enforced by private lawsuits.

1. Rule Claims: The Commission expressed its view when the Rule was issued that private actions should be permitted by the courts for Rule violations (43 FR 59723; 44 FR 49971). To date, no federal court has permitted a private action for Rule violations.
2. State Disclosure Law Claims: Each of the franchise laws in the 15 states with franchise registration and/or disclosure requirements authorizes private actions for state franchise law violations.
3. State FTC Act Claims: The courts in some states have interpreted state deceptive practices laws ("little FTC Acts") as permitting private actions for Rule violations

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